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SUBJECT: CHINA: S&ED II DATES AND TOPICS; RMB APPRECIATION; ECONOMIC SITUATION

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¶1. (SBU) SUMMARY: During a January 25-28 visit to advance preparations for the U.S.-China Strategic and Economic Dialogue II (S&ED II), the U.S. Economic Track staff delegation met with key economic ministries, economists, and U.S. industry representatives. The delegation proposed to their Ministry of Foreign Affairs (MFA) and Ministry of Finance (MOF) interlocutors the week of May 10 for the Dialogue and agreed to exchange outcomes in early March. The group made progress on the public agenda, although the Chinese side noted that it would have difficulty openly including exchange rates and relative prices on the agenda, and resisted listing discussion of China's indigenous innovation policy. Officials were open to continuing private discussions about RMB appreciation, but reiterated China could not be seen as caving to foreign pressure on the currency issue. Turning to China's economic situation, contacts noted that economic overheating and real estate asset bubbles remained an area of concern for Beijing's economic policymakers.  
END SUMMARY.

¶2. (SBU) The delegation met: Ministry of Commerce (MOFCOM) American and Oceanic Affairs Director General (DG) He Ning; Ministry of Finance (MOF) External Economic Cooperation DG Zou Jaiyi; National Bureau of Statistics (NBS) DG Li Xiaochao; China Construction Bank (CCB) Chief Economist Erh-Cheng Hwa; National Development and Reform Commission (NDRC) Cong Liang; State Administration for Foreign Exchange (SAFE) Capital Controls Deputy DG Chu Yumei; UBS economist Wang Tao; Central Finance and Economic Leading Group (CFELG) Vice Minister Liu He; MOF Assistant Minister Zhu Guangyao; Chinese Academy of Social Sciences (CASS) Professors Huang Ping and Xiao Lian; Chinese Institute for Contemporary International Relations (CICIR) Professor Da Wei; China Center for Economic Research (CCER) Scholar Lu Feng; Development Research Center (DRC) Scholar Tang Min; Managing Director of Hill and Knowlton John Holden; Oshkosh Senior Director of Business Development Jennifer Thompson; Akin, Gump, Strauss, Hauer & Feld LLP Partner Spencer Griffith; and IBM Global Services Deputy Chief Representative She Duan Zhi.

¶3. (SBU) State Department Deputy Assistant Secretary for China and Mongolia David Shear and Treasury Department Executive Secretary and Senior Coordinator for China and the S&ED David Loevinger led the State-Treasury S&ED II planning trip to Beijing. The Economic Track delegation also included: Economic Minister Counselor William Weinstein; Treasury Attache David Dollar; Senior Advisor to the Treasury Under Secretary-designate for International Affairs Raji Jagadeesan; Director of Treasury's Office of East Asia Chris Winship; State Department Deputy Director, Office of Monetary Affairs David Meale; Assistant to the U.S.-China Strategic and Economic Dialogue Casey Owens; Deputy Financial Attache to China (incoming) Tim Dorsett; and Embassy EconOffs.

S&ED Planning  
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14. (SBU) On preparations for the Economic Track of the S&ED, neither MFA nor MOF officials replied to the U.S. proposal to hold the Dialogue during the week of May 10, and reiterated China's preference for late May. In a meeting with MOF Assistant Minister Zhu Guangyao, the two sides agreed to exchange proposed Economic Track outcomes in early March. Searching for mutually acceptable phrasing for the public agenda, MOF DG Zou Jiayi, observing that the two sides were "quite close" on most points, said the most difficult area for MOF was exchange rates and relative prices. She preferred not to use exchange rates in the document, as that would attract too much focus, but said the term relative prices was too narrow. Zou also mentioned that the Ministry of Science and Technology (MOST) did not want to discuss the indigenous innovation issue at the S&ED, but hoped to be able to discuss it bilaterally prior to the S&ED; Zou agreed to convey USG views back to MOST.

#### Exchange Rates/RMB Appreciation a "Political Issue"

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15. (SBU) Officials demonstrated little outward receptivity to the message of RMB appreciation. MOFCOM DG He Ning rejected U.S. calls for RMB appreciation, claiming that political pressure from the economic situation in the United States and other countries should not be shifted onto China in the form of a call for RMB appreciation. He pointed out that in 2009 Chinese exports to the United States had dropped 12 or 13 percent, vice an only four percent drop in imports from the United States, without any change in the exchange rate. State Council Economic and Financial Leading Group Vice Minister Liu He noted the currency issue was no longer an economic issue, but more of a "political issue for both sides." Liu explained that exports, while slower, had still helped China

BEIJING 00000352 002 OF 002

successfully create new jobs this year, keep the unemployment rate--and thus the political system--fairly stable.

16. (SBU) Assistant Finance Minister Zhu Guangyao agreed that both China and the United States faced political constraints and pressures with regard to the exchange rate, and urged Washington and Beijing to maintain open communication to manage this issue and keep it out of the public eye as long as possible. Zhu also pointed out that China was worried about inflows of hot money, stemming at least in part from low U.S. interest rates.

17. (SBU) On the other hand, private economists agreed that Chinese officials likely favored a return to gradual appreciation of the RMB, despite the possibility of attracting speculative capital inflows. UBS economist Wang Tao, for example, expected a move mid-year, with a near-term goal of five percent appreciation by year-end 2010. China Construction Bank Vice President/Chief Economist Hwa Erh-cheng agreed that the exchange rate was a "challenge" for the People's Bank of China (PBOC), and even though the PBOC might be forced to allow appreciation, it would only be incremental because the international environment remained fragile and the export recovery was not strong. Predicting that the RMB would rise about three percent in 2010 and five percent in 2011, Hwa concluded that it was unlikely to be a "one-shot" change (e.g. a jump appreciation). China knows it needs to increase domestic demand and consumption to stabilize growth and adjust economic structure in 2010, so the exchange rate issue must eventually be "part of the equation." However, Hwa asserted that the Chinese Government "will not be influenced by a Dialogue."

#### Rising Housing Prices/ Overheating

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18. (SBU) On an overheating economy, Vice Minister Liu He pointed to asset bubbles as a potential problem for China's recovery and noted that people are withdrawing money from banks to invest in assets. Liu did not yet see the problem as serious. As a reaction to the trend, the China Banking and Regulatory Commission (CBRC) has instituted requirements to deter speculation, and the State Council has ordered measures to tighten credit and mandated monitoring of state-owned enterprise (SOE) investment in real estate. NBS DG Li Xiaochao noted that the real estate sector is important to the

economy because it boosts both consumption and investment; however, housing prices jumped 7.8 percent in December, which was a worrisome sign of over-investment and speculation in real estate. On inflation, Li claimed that, although 2009 saw negative inflation, November and December numbers turned positive. Bad weather in December and January, together with the government's proactive fiscal policy, had generated inflationary pressure.

¶9. (SBU) CCB Vice President/Chief Economist Hwa Erh-cheng said the Chinese Government is actively trying to cool the real estate market. Because private companies have been blocked from investing in the service sectors, more investment has flowed to real estate, increasing housing prices by as much as 50 percent in coastal cities. Further adding to the problem, SOEs have out-bid private companies, pushing up land prices. To deter speculation, Hwa said, the CBRC has required banks to disburse loans to real estate suppliers rather than buyers. The market has started to believe that the government will continue to tighten monetary conditions to control overheating.

¶10. (U) The delegation cleared this cable.

HUNTSMAN